Citizens Finance Review Commission

Nonresident Withholding Taxes

Prepared for the Citizens Finance Review Commission

by

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August 22, 2003

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This report was prepared for the Citizens Finance Review Commission with funding and/or assistance from the Arizona Department of Commerce and the Commerce and Economic Development Commission, and may be presented independently elsewhere at the authors' discretion. This report will be available on the Internet for an indefinite length of time at www.azcfrc.az.gov. Inquiries about this report or the Citizens Finance Review Commission should be directed to the Office of the Governor of Arizona, (602) 542-7601.

1. What it is:

Nonresident withholding taxes are income taxes that are withheld by the payor on transactions entered into with nonresidents to ensure that income taxes are properly paid. Approximately 28 states currently impose a withholding tax on specified transactions with nonresidents. Typically, these withholding taxes are imposed on three types of transactions: non-wage income, income distributed by pass-through entities, and real estate sales.

A small number of states, approximately seven, subject non-wages to withholding. Non-wage income includes payments to nonresident independent contractors performing services in the state. Generally, the states specifically limit this to construction activities or the performance of other services performed by out of state contractors. South Carolina and Iowa also subject payments of rent or royalties to nonresidents to a withholding tax. In addition to the tax on services of independent contractors, California imposes a withholding tax on payments made to nonresidents in connection with dividends, royalties and patent rights. Some states establish a de minimis amount which is not subject to withholding unless exceeded.

Approximately twenty-five states have imposed a withholding tax or estimated tax on the distribution or allocation of income to nonresident beneficiaries or owners of interests in pass-through entities to the extent that the income is derived from sources within that state. The tax can be imposed on partnerships, S Corporations, LLCs, estates, and trusts. Rates applied to this income vary among the states but are often tied to the maximum individual or corporate income tax rate. A number of states provide for exceptions to pass-through entity withholding. Some common exceptions include de minimis provisions, acceptance of agreements or certifications from the recipients that tax will be paid, and the filing of a composite return with payment of the tax by the pass-through entity.

Finally, at least nine states require withholding of a percentage of a sale of real estate located within the state by a nonresident. Numerous exemptions to withholding on real estate sales have been established by the states. A few of these include transfers in connection with a foreclosure, sale of principal residences, de minimis rules, and the filing of certifications that tax will be paid by the seller. The states vary with regard to the percentage required to be withheld as well as the base amount upon which the withholding percentage is applied. The withholding tax rate can be applied to the gross proceeds, net proceeds, or gain on sale. Withholding rates range from 2% to 9% and sometimes provide for different rates for different types of taxpayers.

It is important to note that the withholding tax is in the nature of an advance or estimated payment and is not necessarily reflective of the final amount due the state on a particular transaction. Taxpayers may file income tax returns reporting the transaction and due to facts and circumstances relative to their particular situation, might report a final tax liability greater or lower than the amount withheld. In the event that the taxpayer reports a tax liability lower than the amount withheld, a refund would be due to that taxpayer. This system still provides a benefit to the state by collecting the money sooner than might otherwise occur under the current system; thus, improving cash flow to the state and giving the state the benefit of the time value of the money.

2. <u>How it would be administered</u>:

The withholding tax would be collected by the Arizona Department of Revenue (ADOR). The taxes collected would be treated like any other form of withholding and would be applied to a taxpayer's account as in the case of an estimated tax payment. Taxpayers subject to withholding would still be required to file income tax returns to report the transaction and the withholding. These returns would have to be processed and reviewed by ADOR personnel. If additional payments were included or refunds requested, these also would have to be processed.

If a composite return is allowed, these returns would be filed with and the taxes would be remitted to the ADOR. Additional administrative responsibilities could be required of the ADOR if Arizona were to provide for an exemption to withholding upon the filing of a certification, statement, or tax form by the recipient stipulating that the taxes will be paid by the recipient Depending on the form required, the Department might have to review and certify these documents. Alternatively, if the State chose not to require certification, the ADOR might merely retain the forms and use them as a tool for verifying subsequent filings by these taxpayers.

3. <u>Impact on Existing Revenue Systems</u>:

Because this program would be administered by the State and the funds would run directly to the state, there should be no negative impact at the county or local level. Due to the fact that withholding taxes are likely to result in an increase in revenues collected by the State, there might be a positive impact on the cities to the extent that additional revenues would be available to distribute to those jurisdictions in the form of additional revenue sharing dollars.

4. <u>Cost</u>:

While it appears that this would be a fairly straight forward process to implement and administer, the ADOR believes that a significant amount of work would be required to establish the processes and maintain the systems since this does represent a new form of withholding not currently set up at ADOR. Complexities might arise as a result of multiple due dates for the different types of withholding. For example, pass-through entities might be subject to an annual withholding coinciding with the entity's year end and due date for filing. Real estate transactions and non-wage withholding might be set up on a quarterly basis. The ADOR would also have to process and issue withholding numbers to the various taxpayers making these payments. Finally, new administrative rules might need to be developed and existing rules might need to be modified.

.Additional administrative costs would be incurred to modify existing forms or create new forms for the remittance of the taxes. Additional personnel might be required in order to process the filings generated by the provision. This would include processing the additional payments as well as any additional income tax returns filed by nonresidents or composite returns filed by pass-through entities, if provided for. Technically, under the current system, these taxpayers should be filing returns; however, we suspect that a withholding tax might give rise to additional filings due to a low compliance rate under the current system. This increase would be offset by taxpayers who might choose not to file a return where the withholding tax satisfies their tax liability. However, withholding does not remove a taxpayer's obligation to file a tax return; thus, if a return is not filed, the ADOR might have to increase audit efforts in order to ensure that the withholding paid by nonresident taxpayers is the proper amount.

Costs of monitoring the program should be less than the current cost of identifying noncompliance on the part of nonresidents. Currently, according to the ADOR, minimal effort is being placed on auditing compliance with respect to nonresidents earning Arizona taxable income. At the present time, only five field auditors are assigned to auditing pass-through entities. As a result of limited resources, collections resulting from audits of pass-through entities are significantly reduced from prior years. Allocating resources to the processing of withholding payments would be a much more effective means of collecting tax revenue than the current allocation of resources to monitoring compliance.

ADOR does not currently have a means of estimating the cost of implementing and maintaining this program but believes the costs would not be insignificant. However, they do believe that the costs would not be in excess of the additional tax collections that would be generated.

5. <u>Policy Considerations</u>:

A. <u>Equity</u>

A withholding tax is equivalent in horizontal equity to our existing income tax system. A change in law applying withholding taxes to nonresidents on transactions currently subject to Arizona income tax does not create any inequities different from that inherent in the current system. It is merely a tool to increase compliance with the existing tax system. The nonresident withholding tax forces nonresidents, who under the current system may not be paying taxes and who are going undetected by the ADOR, to pay their fair share of income taxes. This could have the result of relieving resident taxpayers of additional tax burden that might be caused by tax increases to make up the shortfall. This promotes equity between resident and nonresident taxpayers subject to income tax.

In addition, nonresident withholding might improve the overall compliance with respect to part-year residents and nonresidents. Requiring withholding might result in part-year residents and nonresidents filing tax returns resulting in a greater level of compliance in other areas of the income tax laws.

A potential inequity could result from implementing a nonresident withholding tax if the withholding rate is set too high or withholding is imposed on transactions that might be exempt with respect to a specific taxpayer (e.g. sale of personal residence or sale of property at a loss) thus requiring nonresident taxpayers to remit to ADOR more taxes than they ultimately will owe. The State would then have to process refunds upon the filing of a tax return showing a lower amount due. The risk of setting the rate too low, however, is that taxpayers who owe more tax, who might have been filing returns and paying the appropriate amount of tax under a system with no withholding, might choose to not file returns and pay additional tax due under a system imposing a withholding tax. Compliance would then be dependent upon audit activities of the ADOR.

In order to avoid these inequities, as well as to minimize the number of income tax returns that might be filed to claim refunds, care should be taken when setting the rates on withholding. Consideration should be given to establishing different rates for nonresident corporations than other types of taxpayers. In addition, certain transactions might be exempt from withholding, such as the sale of personal residences or the sale of personal residences below a certain value. At least four of the states imposing withholding on real estate sales provide for this type of exemption. Alternatively, some states allow nonresidents to file affidavits or certifications stipulating that no tax will be due on the real estate transaction. Attention to these matters when drafting the statute would considerably reduce any inequity associated with this form of withholding.

B. Economic Vitality

Currently, at least 28 states impose some form of withholding tax on nonresidents for these types of transactions. The rate of withholding varies among the states but is frequently tied to the highest rate for individuals, corporations, and in some cases a choice between the two depending on the filing status of the nonresident. Among the ten comparison states, California imposes a withholding tax on all three types of transactions, Georgia and Colorado impose taxes on pass-through entities and real estate sales, and New Mexico and Utah only impose the withholding tax on pass-through entities. Of the comparison states that have an income tax, only Oregon does not impose a withholding tax on nonresidents for these types of transactions. By not currently subjecting these amounts to withholding, Arizona is in the minority of all states as well as the comparison states with respect to this issue. Therefore, imposition of such a withholding tax should not be uncompetitive. However, in order to not discourage activity of these kinds in the state by nonresidents, the rates established should not be excessive or overly burdensome.

C. Volatility

The level of revenue raised by a withholding tax should be moderately volatile and no more volatile than revenues raised through income tax assessments. The withholding tax would be less volatile the broader the application of the tax. In other words, if applied to all three areas commonly subject to withholding taxes in other states, it will be less subject to volatility.

D. Simplicity

A nonresident withholding tax adds very minimal complexity to the tax system. As discussed in question 4; however, there is will be additional work required of personnel at ADOR to implement and administer the program. There might be some added complexity and administration costs to the withholding agents.

6. Economic Impact

Under current systems, the ADOR has no readily available data that would enable us to estimate the economic impact of nonresident withholding on non-wage payments or pass-through entities. Data is available, however, to calculate the impact of imposing a withholding tax on real estate transactions.

During the last three years, total real estate sales broken out between residential and nonresidential have been as follows:

	Total	Nonresidential	Residential
2000	$34,918,549,487	$14,507,459,677	$20,411,089,810
2001	$31,917,878,627	$11,476,564,355	$20,441,314,272
2002	$31,413,932,603	$11,199,072,431	$20,214,860,172

The ADOR tracks sales with either a nonresident seller or buyer. For those years, the sales with a nonresident party to the transaction were as follows, segregated by residential and nonresidential property:

	Total	Nonresidential	Residential
2000	$9,587,034,317	$4,854,928,719	$4,732,105,598
2001	$9,331,862,557	$4,649,192,380	$4,682,670,177
2002	$9,107,262,159	$4,105,787,614	$5,001,474,545

The ADOR does not separately track which party to the transaction is the nonresident. If we assume that these transactions are split evenly between nonresident seller and nonresident buyer the following would represent sales by nonresident sellers:

	Total	Nonresidential	Residential
2000	$4,793,517,158	$2,427,464,359	$2,366,052,799
2001	$4,665,931,278	$2,324,596,190	$2,341,335,088
2002	$4,553,631,079	$2,052,893,807	$2,500,737,272

As discussed in section 1, states calculate the amount of withholding in a number of different ways. A rate can be applied to the gross sales price, the net proceeds, or if provided by the seller, the gain on the transaction. If gross proceeds are used as the taxable base, the rate should be set lower since the likely taxable amount will be lower than the sales price after taking into account basis in the property sold. The rate should be set higher if the withholding is based on the gain to be recognized since this will more closely approximate the ultimate tax to be paid.

The ADOR does not track information regarding net proceeds or gain on sale. States that tax sales price impose a rate ranging from 2% in the case of Colorado to 9% in the case of Rhode Island. California imposes a rate of 3 1/3% of the sales price. If Arizona were to impose a withholding tax of 2 ½% of the sales price on all real estate sales, collections would be as follows:

	Total	Nonresidential	Residential
2000	$119,837,929	$60,686,609	$59,151,320
2001	$116,648,282	$58,114,905	$58,533,377
2002	$113,840,777	$51,322,345	$62,518,432

As mentioned in section 1, many of the states imposing a withholding tax on real estate sales exclude the sale of personal residences entirely or exclude sales below a specific sales price. This is done to avoid having to process large numbers of refunds since many sales of residential real estate are not taxable transactions as a result of the federal law excluding certain gains on the sale of principal residences.

Sales of residential property by value with a nonresident seller (assuming the same 50% rule from above) are categorized as follows:

	2000	2001	2002
Less than $249,999	$1,333,449,938	$1,364,640,522	$1,439,202,950
$250,000 - $499,999	$ 610,752,920	$ 594,105,639	$ 649,865,438
$500,000 - $749,999	$ 179,432,841	$ 177,894,434	$ 185,630,644
$750,000 - $999,999	$ 75,089,996	$ 73,158,217	$ 77,379,430
Over $1,000,000	$ 167,327,103	$ 131,536,276	$ 148,658,811

If only sales equal to or greater than $500,000 were subject to the 2 ½% withholding tax, collections would be contrasted with withholding tax on all residential sales as follows:

	2000	2001	2002
All Sales	$59,151,320	$58,533,377	$62,518,432
Sales $500,000 +	$10,546,249	$ 9,564,723	$10,291,722

Total collections from imposing a 2 ½ % withholding tax under the two scenarios, tax on all transactions and tax on all transactions with an exclusion for residential real estate sales under $500,000 would be as follows:

	2000	2001	2002
All transactions	$119,837,929	$116,648,282	$113,840,777
Exempting Res. RE	$ 71,232,858	$ 67,679,628	$ 61,614,067

Again, please note that this does not necessarily represent an increase or a new source of revenue since some nonresident sellers of real estate may be in compliance with the law. In addition, this also does not necessarily represent total revenues ultimately due to the State, since some taxpayers might file for refunds or pay additional tax due with the return filing if their actual liability differed from the 2 ½% of the sales price.

7. Other

Overall, we believe instituting a withholding tax in Arizona will improve compliance with existing laws and increase revenues to the state. This will have the added benefit of relieving the burden on residents to make up the shortfall through tax increases in other areas. It will also improve the audit function at the ADOR, making it easier to track compliance on the part of nonresidents. Finally, it would result in Arizona being among the majority of states that utilize this method of tax collection.

STATE COMPARISON OF WITHHOLDING ON NONRESIDENTS

state	Non-res. non-wage income	Pass-through entites	Real estate sale by non-res
AL		Partnerships, S Corporations, LLC – must file composite return and pay NR tax unless file agreement with DOR saying NR will file and pay tax	
CA	Services of independent contractors, dividends, royalties, patent rights if greater than $1500/year	Partnership – 7% on domestic NR 9.3% on Foreign NR Corp. Rate on Corporations	Required if greater than $100,000, not principal residence, or no sworn statement that sale is a loss or no taxable gain 3 1/3% of Sales price
CO		Partnership & S Corp. – 4.63% of CO source income, not required if entity files composite return or if NR recipient files form 0107	Required if greater than $100,000 or no written affirmation no tax due, not foreclosure Lesser of 2% of sales price or net proceeds
DE		S Corp. - Highest personal income tax rate on inc. apportioned to DE	
GA		Partnership, S Corp, LLC – 4%, not required if not $1,000 or more or if entity files composite return	Required if greater than or equal to $20,000, tax greater than or equal to $600, not personal residence, or not foreclosure 3% of sales price or gain recognized
HI			Required if not personal residence less than or equal to $300,000
IN		S Corp. – 3.4% plus county rate if applicable, Estates & Trusts – on IN income subject to Adj Gross Inc Tax	
IA	Rents & Royalties, Services provided by independent contractors & others	Estates & Trusts, S Corps, Partnerships LLC – 5%	
KS		Estates & Trusts – 2.5% of KS NR Adj Gross Income	
LA	Prime Contractors- must register with State, pay $10 fee, and post surety bond if work is greater than $3,000.		
ME		S Corp., Partnership, LLC, LLP – Withhold at Max Rate if income is taxable and $1,000 or more	
MD	Services of NR contractor for work greater than $50,000 if not residential real property or if value of improvement greater than or equal to $500,000 – 3%	LLC – Top individual tax rate on NR member's distributive share of LLC's taxable income	Required if no certification that property is personal residence or that no tax is due on sale or not foreclosure 4.75% of net proceeds for individual or 7% if other taxpayer
MN	Construction contracts greater than $100,000 – 8%	Partnership, S Corp	
MS		Partnership, S Corp treated as partnership - Can elect to withhold 5% of NR partner MS net gain or profit	Required if greater than $100,000 Lesser of 5% of amount realized or net proceeds
MO		Partnership, S Corp – Highest individual tax rate on NR's distributive share of income Not required if file composite return, income less than $1,200, or receives form MO-3NR from recipient	

MT		Partnership, S Corp, LLC – Highest marginal rate on NR's share of MT source income Not required if file composite return or receive agreement from NR recipient stating they will file return and pay tax	
NE		Partnership, S Corp, LLC, Estate & Trusts – Highest rate applicable to individuals on NE income Not required if receive form 12N or 14N from NR recipient	
NJ		Partnership or entity taxed as Partnership under Federal law – 6.37% - noncorporate partners' share of income apportioned to NJ or 9% for corporate partners	
NM		Pass-through entities – 7.1% Not required if receive agreement from NR owner	
NY		Partnership, S Corp, LLC – Highest individual tax rate on distributive share of New York Source income Not required if income $300 or less or if file group return	
NC		Pass-through entity – rate set by regulation not to exceed rate on composite returns or in case of NR corporation, maximum corporate rate Not required if NR owner executes agreement to report and pay tax	
OH		Partnership, S Corp, LLC Other Pass-through Entity, Estate & Trust – 5% Not required if adjusted qualifying amount is equal to or less than $1,000 or if composite return filed	
PA		Partnership, S Corp – Personal income tax rate for NR on PA-sourced income allocable to NR	
RI			6% of sales proceeds to NR seller if individual, estate, partnership or trust and 9% if corporation
SC	Rent or royalty payments greater than $1200 for use of SC property – 5% NR corporation, others 7% 2% for NR conducting business or performing personal services if greater than $10,000 Not required if NR is registered	S Corp, Trust & Estate - 5% of S Corp SC income of NR shareholder, 7% of beneficiary distribution attributable to SC income for Trust & Estate	7% of gain recognized of individual, partnership, trust or estate and 5% for corporation or other entity if seller provides buyer with affidavit stipulating gain, withholding on amount realized if affidavit not provided
UT		S Corp – Utah apportioned income rate determined by commission	
VT		Partnership, S Corp, LLC – pay estimated tax if liability greater than $250 per recipient or can file composite return and pay composite tax	2.5% of total consideration paid Not required if certificate filed indicating no tax due, foreclosure